SENATE BILL 495 Implementation, Impacts, and Implications

Part I: Implementation

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PART I: SENATE BILL 495 - IMPLEMENTATION

Part 1 of a two-part report examines the implementation of Senate Bill 495 by the executive. Because the implementation raises crucial questions, emerging issues are being researched and will be presented to the Legislative Finance Committee in "Part II – Impacts and Implications" in a later report.

SUMMARY

Major provisions of Senate Bill 495, enacted by the 2001 legislature to enhance funding for schools and to stabilize the long-term growth of the common school trust fund (school trust), are explained in this report. In addition, important background material is provided in sidebars. Implementation of the legislation by the executive raises numerous questions and issues that will be addressed in a future report to the Legislative Finance Committee. Implementation of the law differs from that anticipated by the legislature. Only a portion of the mineral production rights was purchased and there is no sale/purchase agreement between the Board of Land Commissioners and the Department of Natural Resources and Conservation (the department).

Introduction

Senate Bill 495 authorizes the department to borrow up to \$75.0 million from the coal severance tax permanent fund (coal trust) for 30 years to buy mineral production rights owned by the school trust at fair market value. Money from the purchase is deposited in the school trust as compensation for the sale of the trust assets and generates additional interest earnings that are distributed to schools. Because the mineral production rights are no longer assets of the school trust, mineral royalties from the rights purchased by the department are no longer deposited to the trust. A portion of mineral royalties from the mineral production rights purchased by the department is pledged to repay loan principal with the remaining royalties deposited into the guarantee account (within the general fund). Distributable revenue from the school trust is also deposited to the guarantee account. Money in the account is used to reimburse the general fund for lost coal trust interest and for distribution to schools.

THE LOAN, PURCHASE, AND SALE

The Loan

The legislation authorized the department to borrow up to \$75.0 million from the coal trust to purchase mineral production rights held by the school trust at fair market value. Money from the sale was to be deposited to the guarantee account and spent by transferring it to the school trust to compensate it for the sale of mineral production rights. The fiscal note prepared by the executive assumed that \$37.4 million would be borrowed and deposited to the school trust. Legislative fiscal impact estimates were based on this amount. In actuality, the department (as approved by the Board of Land Commissioners) signed a loan agreement with the Board of Investments to borrow \$46.4 million from the coal trust to purchase only a portion of the total mineral production rights held by the school trust. The remainder of the mineral production rights continues to be held by the school trust. See the attached "The Loan" chart.

The Board of Investments loaned the department \$46,366,904. These funds were from 483,604 shares in the trust fund bond pool owned by the coal trust and valued at \$95.88 per share. Although Senate Bill 495 directs the Board of Investments, to the extent possible, to loan funds in the short-term investment pool to minimize the earning loss to the coal tax trust, all of the money came from long-term investments. The loan is backed by the department's pledge of "net mineral royalties it receives from mineral leases on state school land". "Net" means exclusive of mineral royalties deposited to the trust land administration account.

The Purchase

In House Bill 2, the legislature appropriated \$75.0 million from the guarantee account as a restricted appropriation to the department for the purchase. However, none of this appropriation was used for the purchase. Since the coal trust and the school trust own shares in the trust fund bond pool the "purchase" was made by transferring ownership of \$46.4 million worth of shares from the coal trust to the school trust without an appropriation.

The purchase price of \$46.4 million was determined by the following assumptions made by the department:

- 1. A discount rate of 9.81 percent (the fiscal note assumed a rate of 12.0 percent);
- 2. Total mineral royalties from the school trust totaling \$310,478,578 over 30 years, with yearly amounts increasing from \$8.9 million in fiscal 2002 to \$13.0 million in fiscal 2031;
- 3. Appropriations for trust land operational expenditures increase 3 percent each year, from \$3.7 million in fiscal 2002 to \$8.5 million in fiscal 2031;
- 4. All mineral royalties from mineral production rights retained by the school trust are deposited to the trust land administration account to fund trust land operational costs; and
- 5. Mineral royalties not deposited to the trust land administration account are those obtained from the mineral production rights purchased by the department.

The Sale

Although the Board of Land Commissioners approved the <u>loan agreement</u> signed by the department, there is no corresponding <u>sale agreement</u> between the Board of Land Commissioners, acting in its capacity as fiduciary of the school trust and as seller of some of the trust assets (the mineral production rights), and the department, as purchaser of the trust assets (the mineral production rights). Therefore, there is no documentation that specifies exactly what was sold and what was purchased. Since the department transferred \$46.4 million to the school trust, it is assumed that mineral production rights were sold for which the trust was compensated. See the attached "The Sale/Purchase" chart.

Since only a portion of the school trust mineral rights were sold, it would seem imperative that the Board of Land Commissioners would document precisely which mineral production rights were sold in order to distinguish between the mineral royalties from mineral production rights still owned by the school trust and the mineral royalties from the mineral production rights now owned by the department.

DISTRIBUTABLE REVENUE

In addition to providing that net mineral royalties (the amount remaining after loan repayments) be deposited to the guarantee account (in the general fund), the legislation requires that all realized capital gains and all distributable revenue from school trust lands also be deposited in the account. "Distributable revenue" is defined as 95 percent of all revenue from the management of school trust lands and the school trust, including timber sale proceeds, lease fees, interest, dividends, and net realized capital gains (please see the "House Bill 41" sidebar).

House Bill 41

After SB 495 had been passed, HB 41 amended two sections of SB 495: Section 1(1) that defines "distributable revenue" and Section 3(1) that defines the fund type of the guarantee account.

Exclusions

- 1. Money from the sale of timber in excess of 18 million board feet is diverted into a state special revenue school technology account and is statutorily appropriated to the Office of Public Instruction to buy and maintain technological equipment (HB 41 in the 2001 session enacted the statutory appropriation and changed the fund type from general fund to state special revenue).
- 2. Three percent of income from the school trust (and other land trusts) is diverted into a state special revenue resource development account. The money from each land trust is to be used by the Department of Natural Resources and Conservation to develop the public lands of each trust from which the money came.
- 3. A portion of timber sale revenue from the school trust, determined by the amount appropriated by the legislature, is diverted to a state special revenue timber sale account to be used by the Department of Natural Resources and Conservation for timber sale preparation and documentation.

It is important to emphasize that the diversion of these three sources of revenue from distribution to schools raises constitutional concerns. According to the Code Commissioner, diversions from the common school trust may be unconstitutional. Article X, Section 5 of the Montana Constitution states: "(1) Ninety-five percent of all the interest received on the public school fund and ninety-five percent of all rent, received from the leasing of school lands and all other income from the public school fund shall be equitably apportioned annually to public elementary and secondary school districts as provided by law.

(2) The remaining five percent of all interest received on the public school fund, and the remaining five percent of all rent received from the leasing of school lands and all other income from the public school fund shall annually be added to the public school fund and become and forever remain an inseparable and inviolable part thereof.

However, excluded from the definition is: 1) money from the sale of school trust timber in excess of 18 million board feet; 2) three percent of the income from the school trust, excluding timber sale revenue; and 3) timber sale revenue from the school trust deposited to the state special revenue timber account. These exclusions are "Exclusions" explained in sidebar.

Prior to enactment of Senate Bill 495, distributable revenue was deposited to the general fund. It is now deposited to the guarantee account. Distributable revenue will increase during the 2003 biennium due to additional interest earnings from the \$46.4 million received from the sale of mineral production rights. However, there will be a loss of interest earnings due to the loss of mineral royalties that had previously been deposited to the school trust.

GUARANTEE ACCOUNT

The legislation created a sub-fund within the general fund called the guarantee account (HB 41 amended this portion of the enrolled version of SB 495). The purpose of the account is to "stabilize the long-term growth of the permanent fund [school trust] and to maintain a constant and increasing distributable revenue stream". The following is a list of monies deposited in the account: 1) all realized capital gains and distributable revenue (see "Distributable Revenue" above); 2) the amount of coal trust money borrowed by the department to purchase the school trust mineral production rights; and 3) all royalty payments less the amounts used to repay loan principal to the coal trust. The legislature appropriated \$75.0 million of anticipated loan proceeds from the account for the department to purchase the mineral production rights. With one exception, all money in the account must be distributed to school districts through the basic and per-ANB entitlements. The exception is an annual transfer from the account to the general fund. The amount of the transfer is the amount of interest that would have been earned on the outstanding loan balance in the prior year based on a long-term rate of interest. This transfer reimburses the general fund for the loss of coal trust interest revenue because of the reduction in the coal trust balance (see "Coal Severance Tax Permanent Fund Interest" sidebar).

As implemented, the department actually borrowed \$46.4 million from the coal trust and deposited that amount in the guarantee account. The money was then transferred to the school trust. However, none of the \$75.0 million appropriation was used to purchase the mineral production rights. Instead, the department is using the appropriation to transfer the interest payments to the general fund beginning fiscal 2002. The legislature anticipated interest payments to begin in fiscal 2003.

MINERAL ROYALTIES

Any discussion of school trust mineral royalties must mention the enactment of Senate Bill 48 by the 1999 legislature. Prior to that time, all royalties from the production of minerals on school trust

land (and all other trust

lands) were considered

part of the school trust

Considerations

According to the Code Commissioner, diversions of school trust corpus violates the Montana Constitution. Article X, Section 2 defines the corpus of the school trust to be: "Proceeds from the school lands which have been or may hereafter be granted by the United States..."

Therefore, spending the corpus of the school trust violates Article X, Section 3 of the Montana Constitution that states: "The public school fund shall remain inviolate, guaranteed by the state against loss or diversion".

Senate Bill 495 allows the sale of school trust mineral production rights to the department and directs that any royalty payments received by the Board of Land Commissioners, less amounts used to reimburse the coal trust for the loan principal, be deposited to the guarantee account discussed above. Thus, mineral royalties from school trust lands from which the department purchased mineral production rights no longer apply to SB 48 and are unavailable for the department to spend. This means that these royalty payments are only used: 1) to repay the principal of the coal trust loan; and 2) for any purpose allowed to be funded by the guarantee account, such as distributions to school districts and transfers to the general fund for loan interest payments. Repayment of loan principal to the coal trust begins in fiscal 2004 based on statutorily set percentages of mineral royalties (see "Loan Agreement" sidebar). See the attached "Mineral Royalties/Loan Payments" chart.

Coal Severance Tax Permanent Fund Interest

Interest earnings from the coal trust are deposited to general the (excluding interest earnings from the treasure state endowment fund and the treasure state endowment regional water system fund which are deposited to state special revenue funds and appropriated by the legislature). It was estimated that deposits would be \$36.4 million in fiscal 2002 and \$36.3 million in fiscal 2003. This revenue source contributes about 2.6 percent of all general fund revenue.

corpus and were returned to the trust (see the "Considerations" sidebar). Senate Bill 48 diverted a portion of the following money (previously deposited to the corpus of the trust funds): 1) mineral royalties; 2) the proceeds or income from the sale of easements and timber (except timber from school trust lands); and 3) five percent of the interest and income previously credited annually to the school trust (see the previous "Exclusions" sidebar about Article X, Section 5 of the Montana Constitution that addresses this five percent). The money is diverted to a state special revenue trust land administration account to pay costs incurred by the department for administering state trust lands.

Loan Agreement

Statute directs the Board of Investments to enter into a contract with DNRC pledging the following percentages of mineral royalties over a period of 30 years to repay the loan:

- ?? 20% for fiscal years 2004 and 2005
- ?? at least 25% for fiscal years 2006 through 2011
- ?? at least 34% after fiscal 2011

The actual loan agreement provides for:

- ?? 20% for fiscal years 2004 and 2005
- ?? 25% for fiscal years 2006 through 2011
- ?? 34% for fiscal years 2012 through 2017
- ?? 45% until the loan is repaid

CONSTITUTIONAL AMENDMENT

Senate Bill 495 also amends statutes to remove the restriction of investing public funds (except retirement funds which have no such restriction) in common stock of a corporation. This amendment would become effective on January 1, 2003, if Senate Bill 493 (which is an amendment to the Montana Constitution that would remove the restriction of investing public funds in private corporate stock) is approved by the electorate in November 2002.

CONCLUSION

Part I of this report provides background material pertaining to Senate Bill 495 and discusses implementation of the legislation by the executive. The report also highlights areas of potential issues that will require further research. Part II will provide the Legislative Finance Committee with the results of this research by providing an analysis of specific impacts of the legislation and their associated issues.

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